Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:CTM:[redacted]:POSTF-124710-02
[redacted]

date: May 24, 2002

to: [redacted], Team Coordinator

from: [redacted], Attorney (LMSB)

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subject: [redacted]
Joint Committee Review of [redacted] Professional Fees Claim for Refund

We recommend that the audit team reevaluate the proposed resolution of [redacted]'s claim for refund regarding the taxable year [redacted] professional fees issue. We think [redacted] should be allowed a deduction in [redacted] for previously incurred reorganization costs only to the extent [redacted] can establish the existence and basis of the intangible asset of "[redacted]." If [redacted] cannot meet this heavy burden, this claim for refund should be disallowed in full. This memorandum should not be cited as precedent. (Our normal post-review procedure of this advice will serve to provide National Office coordination of this [redacted] issue.)

Issue:

Can [redacted] deduct as an abandonment loss in [redacted] ([redacted]) any portion of the capitalized professional fees incurred during the [redacted] leveraged buy-out?

Discussion:

In [redacted], entities (New [redacted]) controlled by [redacted] ([redacted]) acquired [redacted]% of the stock of [redacted] (Old [redacted]) in a leveraged buy-out. Old [redacted] was merged into the New [redacted] entities and the parent New [redacted] was renamed [redacted]. Old [redacted] paid professional fees of approximately $[redacted] in connection with this acquisition. Old [redacted] capitalized $[redacted] of these fees and deducted the remaining $[redacted] on its original return. The ensuing dispute over how much of said fees were deductible was resolved by allowing [redacted] a current deduction of approximately $[redacted]. This resolution was recorded in a closing agreement that provided that the remaining portion of the fees represents:

[redacted]

[redacted].

In [redacted], [redacted] authorized and sold in a public offering common stock equaling approximately an [redacted]% interest in [redacted]. In a claim for refund for the [redacted] year submitted [redacted], [redacted] made the following argument:

[redacted]

Besides disagreeing with [redacted]'s factual assertion that the only benefits from the LBO were the benefits of [redacted], we also disagree with [redacted]'s legal analysis of INDOPCO v. Commissioner, 503 U.S. 79, 117 L Ed 2d 226 (1992). According to [redacted], the professional fees were capitalized in the closing agreement under the INDOPCO rationale. In INDOPCO, the Supreme Court held that expenditures that resulted in significant long-term benefits should be capitalized, even if such expenditures did not serve to create or enhance a separate and distinct asset. The three categories of long-term benefits identified in the INDOPCO case were resource-related benefits, operational synergies and the benefits attributable to going private. The [redacted] claim argues that since [redacted].

On the contrary, we think the INDOPCO opinion discussed these three long-term benefits because those benefits were present in that case, not because those were the only possible long-term benefits from a corporate merger. Far from limiting the scope to the holding to enumerated long-term benefits, the Supreme Court quoted with approval language from past decisions holding that expenses "incurred for the purpose of changing the corporate structure for the benefit of future operations are not ordinary and necessary business expenses." INDOPCO, supra, 117 L Ed 2d at 237 (citations omitted). Once capitalized, the general rule is that capitalized reorganization expenses are deductible only when a corporation liquidates: "efforts to deduct reorganization expenses before a taxpayer's final liquidation, upon an event such as recapitalization that eliminated stock previously created, have fail, and properly so." Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders, ¶ 5.06[2][h] (7th Ed. 2000) (footnote omitted).

[redacted] may further argue that even if the LBO produced other benefits besides the benefits of [redacted], the LBO did produce the benefits of [redacted] so a portion of the capitalized professional fees should be allocated to such benefits, and that portion deducted in [redacted] when the [redacted] benefits were abandoned. This possibility appears to be theoretically consistent with Newark Morning Ledger v. United States, 507 U.S. 546 (1993), where the Supreme Court allowed a newspaper publisher to amortize an intangible asset (an acquired subscribers list) where the taxpayer established the basis and useful life of the intangible asset with reasonable accuracy.

Under this approach, [redacted] would have to establish the existence of a separate intangible asset ([redacted]) and its basis. We are not aware, however, of any contemporaneous statements or other evidence in connection with the [redacted] LBO that would tend to establish either the existence or the basis of a "[redacted]" intangible asset. The contemporary statement of [redacted] quoted above, regarding [redacted]'s plans to become a public company [redacted] tends to establish the opposite – far from being a valuable benefit, to [redacted].

Another consideration is the language of the closing agreement. The closing agreement states only that the capitalized fees were incurred "[redacted]. . . ." While this language obviously does not specify anything about [redacted]'s acquisition of the benefits of [redacted], in our view the closing agreement language is not determinative of this issue. Since the transfer of Old [redacted]'s stock to (New) [redacted] constituted the change from [redacted] ownership, [redacted] could argue that the closing agreement language is consistent with the acquisition of the benefits of [redacted]. We believe that evidence of the existence and basis of a [redacted] intangible asset from a date closer in time to the [redacted] LBO is more persuasive than the [redacted] closing agreement.

Lastly, we note that the recently issued Advance Notice of Proposed Rulemaking (ANPR) concerning capitalization of intangibles, Announcement 2002-9 (February 19, 2002), does not appear to bear on this issue. Under Section C., Transaction Costs, the ANPR states that the proposed rule is expected to require capitalization of transaction costs that facilitate the taxpayer's acquisition, creation, restructuring, or reorganization of a business entity. The ANPR does not, however, discuss any circumstances where capitalized transaction costs later become deductible.

If you have any questions, please contact me.

[redacted]
Attorney (LMSB)

cc: Area Counsel
Team Manager